2
Basic Concepts in Auditing

Learning Objectives

After reading this chapter, student should be able to -

- Understand the concepts of auditor's independence, its importance under the Companies Act and Chartered Accountants Act.
- Explain Audit evidence, Sufficiency and appropriateness of audit evidence, types of audit evidence, relevance and reliability of audit evidence, and also methods to obtain audit evidence.
- Understand materiality, its definition as per AS 1 and judge the materiality of the item in different circumstances.
- Explain concepts of true and fair and disclosure of accounting policies.
- Understand the Fundamental Accounting Assumptions.

2.1 Concept of Auditor's Independence

Professional accountants have an important role in society. Investors, trade payable, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behaviour of professional accountants in providing such services have an impact on the economic well-being of their community and country. Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance.

In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles as under:

Integrity: A professional accountant should be straightforward and honest in performing

professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.

Technical Standards: A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of professional accountants in public practice, independence.

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individuals to adopt an unbiased view on the matters undaunted by any favour or frown. In all matters relating to the assignment, independence in mental attitude is to be maintained. Only so long as the auditor maintains a high standard of independence and impartiality, the audit reports will continue to be accepted and respected by business, financial institutions, Government and investors. Professional integrity and independence are essential characteristics of all the learned professions but are more so in the case of accounting profession.

Independence is a state of mind and personal character and an enlightened view of the professional duties involved. Independence is much affected by the state of the profession, i.e., the ability and willingness to enforce a proper code of ethics as well as its ability to withstand pressures. The more the esteem for the profession in the public eyes because of the standards of independence prescribed by it for its members, greater the reliance there would be on the reports and opinions given by the members of the profession. Independence, as has been stated earlier, is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances.

Independence of auditor must not only exist in fact, but should also appear to exist to all reasonable persons. This is very important because very often the relationships are misunderstood. It is, therefore, necessary that relationship maintained by the auditor shall be

such that no reasonable man can doubt his objectivity and integrity.

The Guidance Note issued by the ICAI on “Independence of Auditors” contemplates that it is not possible to define “Independence” precisely. According to it, “independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self-interest. It stipulates that the independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgment of the auditors’ independence. There is also a collective aspect of independence that is important to the accounting profession as a whole.

The chartered accountant is not personally known to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountant, provisions requiring special resolution for appointing auditors in certain cases and other provisions on appointment, reappointment and removal of auditors are designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users. The vast powers of access given to the auditor to the books of account and other documents of the company are specifically designed to give independence to the auditors. The power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. The enactment of specific instances of misconduct in the Schedules to the Chartered Accountants Act, 1949 is yet another attempt to keep the independence and professional competence of the accounting profession.

In order to ensure independence, the law has also made certain provisions which put either prohibitions or regulations in the matter of appointment of auditors -

Accordingly a person is disqualified to act as an auditor from being appointed as such if he is :

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner -

  (i) is holding any security of or interest in the company or its subsidiary, or of its holding or

associate company or a subsidiary of such holding company:

It may be noted that the relative may hold security or interest in the company of face value not exceeding rupees one lakh;

It may also be noted that the condition of rupees one lakh shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities:

It may further be noted that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor within sixty days of such acquisition or interest.

(ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh; or

(iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of one lakh rupees;

(e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

Student may note that for the purpose of clause (e) above, the term “business relationship” shall be construed as any transaction entered into for a commercial purpose, except -

(i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;

(ii) commercial transactions which are in the ordinary course of business of the company at arm’s length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

(f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

The following are some specific instances where the question of independence vis a vis indebtedness has been considered:

1. The Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of his engagement by a client the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.
2. Where an auditor purchases goods or services from a company audited by him on credit he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh he is disqualified for appointment as an auditor of the company and has to vacate his office. It will not make any difference if the company allows him the period of credit as it allows to other customers in the normal business. He, in fact, in such a case also has become indebted to the company and consequently has to vacate his office.
3. A partner is disqualified when a firm in which he is a partner is indebted to the company for a sum exceeding rupees five lakh. Similarly, a firm is disqualified if a partner of that firm is so indebted.

2.2 Audit Evidence

2.2.1 Introduction: Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) **Information contained in the accounting records :** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations,

computations, reconciliations and disclosures.

(2) **other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements.**

Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

2.2.2 Sufficiency and Appropriateness of Audit Evidence:

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

Sufficiency of Audit Evidence: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

(i) Materiality

(ii) Risk of material misstatement

(iii) Size and characteristics of the population.

(i) Materiality may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(ii) Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) Size of a population refers to the number of items included in the population. .Less evidence would be required in case of smaller, more homogeneous population But on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence*:* Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330, "The Auditor's Responses to Assessed Risks" requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgement. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

2.2.3 Sources of Audit Evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

For example-

- through analysis and review,

- reperforming procedures followed in the financial reporting process,

-and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

2.2.4 Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

  (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

  (ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor

Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Nature and Timing of the Audit Procedures

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of

some information for the auditor's review or to perform audit procedures at a time when the information is available.

Audit Procedures

Audit procedures to obtain audit evidence can include :

(i) Inspection

(ii) Observation

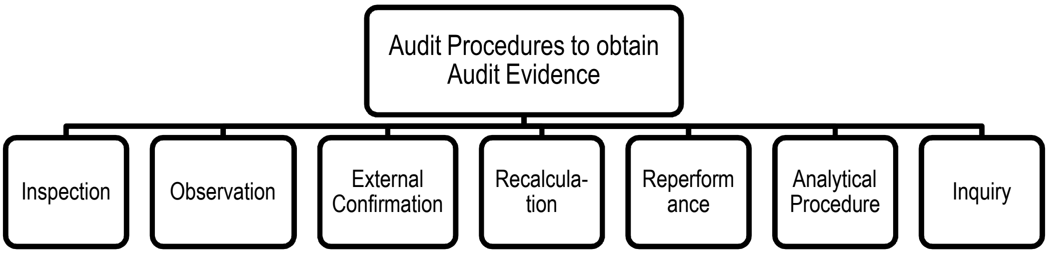
(iii) External Confirmation

(iv) Recalculation

(v) Reperformance

(vi) Analytical Procedures

(vii) Inquiry



Inspection: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation: Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the

process or procedure is performed.

External Confirmation: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

Recalculation: Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Re-performance: Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Inquiry: Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to

confirm responses to oral inquiries.

At this stage, it would be pertinent to discuss further audit procedures, which comprise:

(i) ***Tests of controls, when required by the SAs or when the auditor has chosen to do so; and***

(ii) ***Substantive procedures, including tests of details and substantive analytical procedures.***

Tests of controls: Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) ***The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or***

(b) ***Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.***

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Tests of Controls

In designing and performing tests of controls, the auditor shall:

(a) ***Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:***

   (i) ***How the controls were applied at relevant times during the period under audit.***

   (ii) ***The consistency with which they were applied.***

   (iii) ***By whom or by what means they were applied.***

(b) ***Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.***

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the

point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of tests of controls include the following:

- *The frequency of the performance of the control by the entity during the period.*
- *The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.*
- *The expected rate of deviation from a control.*
- *The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.*

The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Timing of Tests of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using Audit Evidence Obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

(a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

(b) The risks arising from the characteristics of the control, including whether it is manual or automated;

(c) The effectiveness of general IT-controls;

(d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

(e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

(f) The risks of material misstatement and the extent of reliance on the control.

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Specific inquiries by auditor when deviations from controls are detected.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

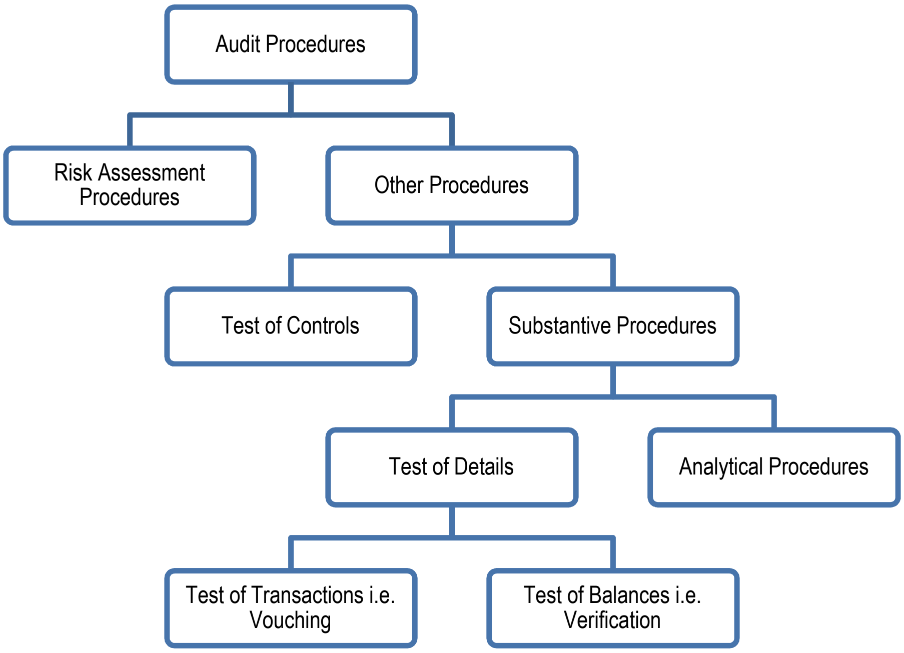
Substantive Procedures

Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures), and

(ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:



Designing and Performing Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

(i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and

(ii) there are inherent limitations to internal control, including management override.

2. Depending on the circumstances, the auditor may determine that:

- *Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.*
- *Only tests of details are appropriate.*
- *A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.*

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.

6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

External Confirmation as Substantive Procedures.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

1. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- *Bank balances and other information relevant to banking relationships.*
- *Accounts receivable balances and terms.*
- *Inventories held by third parties at bonded warehouses for processing or on consignment.*
- *Property title deeds held by lawyers or financiers for safe custody or as security.*
- *Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.*

- *Amounts due to lenders, including relevant terms of repayment and restrictive covenants.*
- *Accounts payable balances and terms.*

2. *Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.*
3. *The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.*
4. *Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:*
   - *The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.*
   - *The ability or willingness of the intended confirming party to respond – for example, the confirming party:*
     - *May not accept responsibility for responding to a confirmation request;*
     - *May consider responding too costly or time consuming;*
     - *May have concerns about the potential legal liability resulting from responding;*
     - *May account for transactions in different currencies; or*
     - *May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.*

   In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

   - *The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.*

Substantive Procedures Related to the Financial Statement Closing Process

The auditor's substantive procedures shall include the following audit procedures related to

the financial statement closing process:

(a) Agreeing or reconciling the financial statements with the underlying accounting records; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature, and also the extent, of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The above paragraph requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

The Use of Assertions

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:
   (a) Assertions about classes of transactions and events for the period under audit:
      (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
      (ii) Completeness—all transactions and events that should have been recorded have been recorded.
      (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
      (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
      (v) Classification—transactions and events have been recorded in the proper accounts.
   (b) Assertions about account balances at the period end:
      (i) Existence—assets, liabilities, and equity interests exist.
      (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
      (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
      (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
   (c) Assertions about presentation and disclosure:
      (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
      (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
      (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
      (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.
3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

4. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed. For example, when we find in the balance sheet, an item under current assets reading as "cash in hand - ₹ 8,000" the obvious assertions that would strike the mind are the following:

(i) the firm concerned had ₹ 8,000 in hand in valid notes and coins on the balance sheet day;

(ii) that the cash was free and available for expenditure to the firm; and

(iii) that the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

Take another example:

		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	83,000
		1,17,000

The assertions are as follows:

(i) the firm owns the plant and machinery;

(ii) the historical cost of plant and machinery is ₹ 2 lacs;

(iii) the plant and machinery physically exists;

(iv) the asset is being utilised in the business of the company productively;

(v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and

(vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements. Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading. An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

(i) the name of the lender, if it is relevant;

(ii) the nature of security provided; and

(iii) the rate at which interest in payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as “building”, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

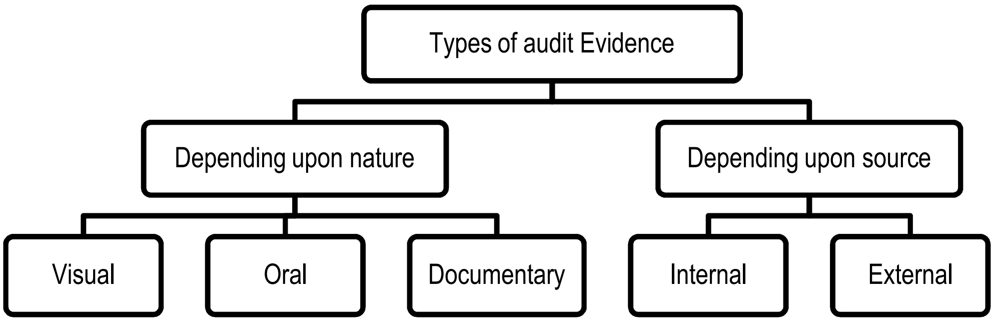
Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present “the results of operations” a balance sheet purports to present “financial position”. The auditor’s opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgments of these specific assertions he arrives at a judgement on the financial statement as a whole.

Some observations about audit evidence may be of help in deciding upon the techniques to be adopted for obtaining them. First, there is nothing mysterious about the evidence which an auditor can obtain and on which he relies; it is straight forward information, some of it is obtained only by diligent effort but all of it is of the common sense variety. Second, evidence varies in reliability. When the auditor recalculates certain figures, like depreciation or inventory valuation, he may be completely convinced about the reliability of the company’s figure. However information supplied by an employee may not be that reliable because he may have an interest in concealing rather than revealing the truth. This suggests that we must always be alert to the relative reliability of different kinds of evidence. Third, some evidence may be more difficult to obtain than other. It is relatively easy to put questions to employees who are present inside the company. It is easy to examine inventory on hand; it is more difficult to verify inventory stored elsewhere. Fourth, it must be recognised that the available evidence be persuasive and that the evidence may not be conclusive. In giving the opinion, the auditor necessarily takes a calculated risk. He gets the best evidence reasonably available and forms his judgment accordingly. In fact, in auditing it is very difficult and at times impracticable to obtain conclusive evidence both on account of time and cost constraints. This explains why an auditor gives an opinion rather than some kind of guarantee or certificate. All he can state is that he has carefully examined the various assertions in the financial statements, obtained evidence what he, in his professional judgement, thought adequate or the best available; and that he has considered that evidence judiciously in forming an opinion as to the reliability of the financial statements. Fifth, the auditor may gain increased assurance when audit evidence

obtained from different sources of a different nature is consistent. In the circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely when audit evidence obtained from one source is inconsistent with that obtained from another, further procedure may have to be performed to resolve the inconsistency. Sixth, the auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated. Seventh, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty and expenses involved in testing a particular item is not in itself a valid basis for omitting a procedure. Eight, when the auditor is in reasonable doubt as to any assertion he should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should not express an unqualified opinion.

2.2.4 Types of Audit Evidence: Internal evidence and external evidence: Evidence which originates within the organisation being audited is internal evidence. Example-sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organisation; for example, purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.



In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see as to what extent

the various internal evidence corroborate each other.

2.2.5 Relevance and Reliability: Since the audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance: Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

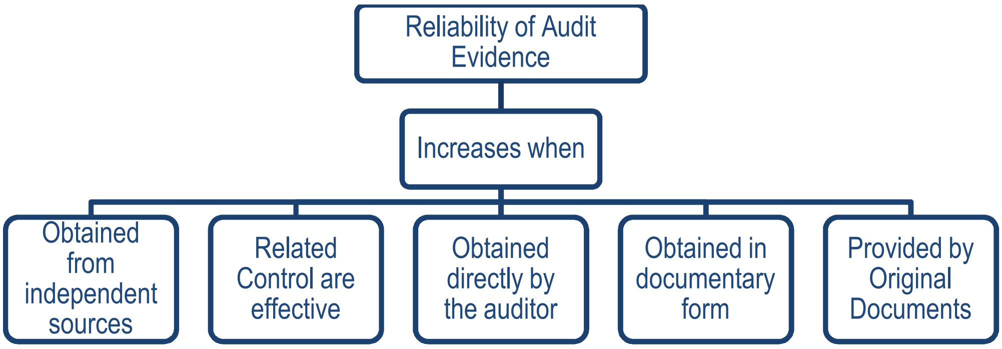
Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be

reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.



2.3 Concept of Materiality

The concept of materiality is fundamental to the process of accounting. It covers all the stages from the recording to classification and presentation. It is, therefore, an important and relevant consideration for an auditor who has constantly to judge whether a particular item or transaction is material or not. SA-320 on Materiality in Planning and Performing an Audit lays down standard on the concept of materiality and its relationship with audit risk. It deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450, "Evaluation of Misstatements Identified during the Audit", explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. Obviously,

an auditor requires more reliable evidence in support of material items. He also has to ensure that such items are properly and distinctly disclosed in the financial statements.

“Accounting Standard 1 defines material items as relatively important and relevant items, i.e. “items the knowledge of which would influence the decisions of the users of the financial statements”. Whether or not the knowledge of an item would influence the decisions of the users of the financial statements is dependent on the particular facts and circumstances of each case. It is not possible to lay down precisely either in terms of specific account or in terms of amounts the items which could be considered as material in all circumstances. Materiality is a relative term and what may be material in one circumstance may not be material in another. Therefore, the decision to judge the materiality of the item whether in the aggregation of items, presentation or classification of items shall depend upon the judgment of preparers of the account in the circumstances of the particular case. In many cases percentage comparison may be useful in indicating the materiality of an item. **As per SA 320, this percentage criteria for determining materiality levels is known as Benchmarking. For example, Part II of Schedule III to the Companies Act, 2013** requires that any expense exceeding one per cent of the total revenue of the company or ₹ 1,00,000 whichever is higher, shall be disclosed by way of notes as additional information and shall not be combined with any other item to be shown under miscellaneous expenses. Actually the detailed disclosure requirements of Schedule III to the Companies Act, 2013 seek to ensure that the financial statements disclose all material items so as to give a true and fair view of the state of affairs of the company. Apart from the percentage criterion, the relative significance of an item has to be viewed from many angles while judging its materiality. It is generally felt that in respect of items appearing in the profit and loss account and having an effect on the profit for the year, materiality should be judged in relation to the group to which the asset or the liability belongs, for example, for any item of current asset in relation to total current assets and any item of current liability in relation to total current liabilities. Another angle to judge the materiality of the item can be to compare it with the corresponding figure in the previous year. Suppose the item is of a low amount this year but it was of a much higher amount in the previous year then it becomes material when compared to the corresponding figure of the previous year. Thus, materiality of an item can be judged: (a) from the impact that the item has on the profit or loss or on the balance sheet, or on the total of the category of items to which it pertains, and (b) on its comparison with the corresponding figure of the previous year. In many circumstances even small amount may be considered material. Thus, if there is a statutory requirement of disclosure of amount paid as sitting fee to directors the amount so paid must be disclosed precisely and separately. Similarly, a payment of ₹100 to directors as remuneration in excess of statutory limits may be material. A small inaccuracy may be considered material if it further depresses or boosts a low profit or converts a small loss into a profit or vice versa. Similarly, if it creates or eliminates a margin of insolvency in the balance sheet, it will be a material item. Transaction of abnormal or non-recurring nature is also considered material even though the amount involved may not be significant. In off-setting and aggregating items, care must be taken to see that items which are independently material are not set-off against each other. For example, the surplus arising from a change in the basis of accounting may not be set-off

against a non-recurring loss. Even as item with a nil or small balance may assume materiality in a situation where it was not expected to be nil or insignificant.

Thus, materiality is an important and relevant consideration for the auditor also because he has to evaluate whether an item is material in giving or distorting a true and fair view of financial statement. He also has to ensure that a material item is disclosed separately and distinctly or atleast clear information about the item is available in the accounting statements.

The relationship between audit materiality and risk is explained in Chapter 3.

2.4 Concept of True and Fair

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

The importance of the concept of true and fair view can also be understood and appreciated from the fact that sections 128, 129 and 143 of the Companies Act, 2013 also discuss this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term "financial statement" shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) of section 129 shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

In the context of audit of a company, the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule III to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule

III of the Companies Act, 2013 and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with. It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and fair' view is a matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see: (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles, (ii) no material asset is omitted; (iii) the charge, if any, on assets are disclosed; (iv) material liabilities should not be omitted; (v) the profit and loss account discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with Part I of Schedule III; (vii) accounting policies have been followed consistently; and (viii) all unusual, exceptional or non-recurring items have been disclosed separately.

In this context, it is noteworthy that the Council of the Institute while issuing a clarification regarding authority attached to documents issued by the Institute also observed that, "The Companies Act, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 2013 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The pronouncements issued by the Institute include various statements, standards and guidance notes.

2.5 Disclosure of Accounting Policies

2.5.1 Nature of Accounting Policies: Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

The various statements of the Institute of chartered accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of a corporate enterprise. While continuing efforts in this regard in the future are likely to reduce

the number still further the availability of alternative accounting principles and methods of applying those stances faced by the enterprises.

2.5.2 Areas in which Different Accounting Policies are encountered: The following are examples of the areas as given in AS 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortisation
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Valuation of fixed assets

Note: (The above list is not exhaustive. There may be other examples as well.)

2.5.3 Disclosure of Accounting Policies: The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

The purpose of AS-1 is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes and form part of financial statements.

Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

2.5.4 Fundamental Accounting Assumptions: Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumption:

(a) Going Concern: The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing.

(b) Consistency: It is assumed that accounting policies are consistent from one period to another.

(c) Accrual: Revenues and costs are accrued, that is recognised as they are earned or incurred (and not as money is received or paid) and recognised in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this statement.)

If the fundamental accounting assumptions, viz., Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.